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No. 10-928

Supreme Court, U.S.
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In The

Supreme Court of the United States

IRA NATHEL, TRACY NATHEL,
SHELDON NATHEL, and ANNE M. NATHEL,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit

REPLY BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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TABLE OF CONTENTS

Page

POLICY ARGUMENT FOR RE-AFFIRMING *GLENSHAW GLASS* AND *GITLITZ* 1

THE EQUAL APPLICATION OF THE RULE OF LAW IN THE COURT'S USE OF THE DEFINITION OF INCOME 3

SECOND CIRCUIT PANEL FOUND THAT A CONTRIBUTION TO CAPITAL IS NOT INCOME, THUS NOT UNDER THE S CORP BASIS ADJUSTMENT RULES..... 5

CAPITAL CONTRIBUTIONS ARE GROSS INCOME UNDER *GLENSHAW GLASS* 5

Two Circuit Courts have already ruled that a contribution to capital is gross income under Section 61 5

Respondent is Mistaken Regarding Any Continuing Vitality to the Pre-*Glenshaw* Definitions of Income 7

Respondent and Second Circuit Are Also Mistaken in Relying on Treas. Reg. 118-1 9

How the Second Circuit Should Have Applied *Glenshaw* 11

THE SECOND CIRCUIT DISTINGUISHED *GITLITZ* ON THE GROUNDS THAT *GITLITZ* INVOLVED AN ITEM THAT WAS GROSS INCOME LISTED IN SECTION 61(A) BEFORE EXCLUSION BY SECTION 108(A) 11

TABLE OF CONTENTS – Continued

Page

BY STATUTE THE S CORP BASIS ADJUSTMENT RULES ARE INDEPENDENT OF THE C CORP RULES 13

CONCLUSION..... 14

TABLE OF AUTHORITIES

Page

CASES

AT&T, Inc. v. U.S., 629 F.3d 505 (5th Cir. 2011).....9

Commissioner v. Collins, 3 F.3d 625 (2d Cir. 1993).....1, 8

Commissioner v. Glenshaw Glass, 348 U.S. 426 (1955).....*passim*

Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990).....9

Commissioner v. Kowalski, 434 U.S. 77 (1977).....9

Edwards v. Cuba R.R. Co., 268 U.S. 628 (1925).....8

Eisner v. Macomber, 252 U.S. 189 (1920).....1, 2, 8

Gitlitz v. Commissioner, 531 U.S. 206 (2001).....*passim*

James v. U.S., 366 U.S. 213 (1961).....4

Mas One Limited Partnership v. U.S., 390 F.3d 427 (6th Cir. 2004).....6, 7, 14

Nathel v. Commissioner, 615 F.3d 83 (2d Cir. 2010).....*passim*

Teleservice Co. of Wyoming Valley v. Comm., 254 F.2d 105 (3d Cir. 1958).....9

Twenty Mile Joint Venture v. Commissioner, 200 F.3d 1268 (10th Cir. 1999).....6

TABLE OF AUTHORITIES – Continued

Page

STATUTES

All references to Sections are to the Internal Revenue Code, 26 U.S.C.

Section 61 ..... 4, 5, 10

Section 61(a) ..... *passim*

Sections 101 through 136 3

Section 108(a) 4, 11

Section 118 ..... *passim*

Section 118(a) 4

Section 351 8

Section 475(f) 8

Section 721 ..... 6, 7, 12

Section 1001 8

Section 1033 8

Section 1256 8

Section 1366(a)(1)(A) 12

Section 1367 ..... 2, 13, 14

REGULATIONS

Treasury Regulation 1.118-1 9

SUPREME COURT RULES

Rule 10(c) 1

TABLE OF AUTHORITIES – Continued

Page

OTHER AUTHORITIES

COORDINATED ISSUE PAPER ALL INDUSTRIES EXCLUSION OF INCOME: NONCORPORATE ENTITIES AND CONTRIBUTIONS TO CAPITAL UIL: 118.01-02 (2008) 6

REPLY BRIEF FOR PETITIONER

1) The Second Circuit has overruled this Court's opinion in *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955) (and its many progeny) and revived the previously abandoned definition of income based on capital and labor, as set forth in *Eisner v. Macomber*, 252 U.S. 189 (1920).

2) The Second Circuit has overruled this Court's opinion in *Gitlitz v. Commissioner*, 531 U.S. 206 (2001) regarding the classification of capital contributions as an "item of income" for purposes of the S Corp basis adjustment rules.

Respondent has not disputed that Rule 10(c) applies to the *Nathel v. Commissioner*, 615 F.3d 83 (2d Cir. 2010) case as a decision by a Court of Appeals that has been decided on an important federal question in a way that is in direct conflict with relevant decisions of the Supreme Court.

POLICY ARGUMENT FOR RE-AFFIRMING *GLENSHAW GLASS* AND *GITLITZ*

Without acknowledging the gravity of the issue, the Second Circuit has ignored and rejected this Court's definition of income and attempted to revive a definition of income abandoned by this Court in *Glenshaw*, and the Second Circuit's own precedent in *Commissioner v. Collins*, 3 F.3d 625 (2d Cir. 1993). If the Second Circuit is allowed to effectively overrule *Glenshaw*, without reversal by this Court, taxpayers relying on the Second Circuit language regarding

items not listed in Section 61(a) may reasonably declare that an item not listed in Section 61(a) (e.g. punitive damages or lottery winnings) is not income and therefore cannot be taxable income, using the previously abandoned, but now revived "capital and labor" analysis.[1] Reliance on Section 61(a) to differentiate between *Gitlitz* and *Nathel* is reversible error, for if the Court relies on Section 61(a), instead of *Glenshaw*, then the Court is opening up the gates for taxpayers to rely on the *Eisner v. Macomber*, 252 U.S. 189 (1920) definition and attack as "not an item of income" those items of income that are not related to capital or labor. The Second Circuit panel restricted the definition of income despite the fact that *Glenshaw* expanded it to include not only income related to capital and labor but to all accessions to wealth whether related to capital or labor or not.

The Second Circuit's apparent overruling of this Court's ruling in *Gitlitz*, is based on a distinction without a difference and rejects the logic and reasoning of this Court on the clear meaning and necessary conclusion Congress intended when it used the words

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[1] Other issues may arise with basis adjustment rules involving "items of tax-exempt income," but as discussed in *Gitlitz*, reacting by redefining income creates more problems than it solves. Congress could have chosen to restructure the statute without leaving the Courts to manipulate the definition of tax-exempt income in order to fix the statute. (After *Gitlitz*, Congress put a band-aid on the statute regarding Cancellation of Debt income, instead of providing a full re-write of Section 1367).

"gross income does not include" in Sections 101 to 136. While it is difficult to argue that the details of the S Corp basis adjustment rules are of the highest national import, the maintenance of a single national rule of law in any one area must be.

What speaks most loudly is the Respondent's silence regarding the definition of income in *Glenshaw*, and applied by this Court and in its progeny hundreds of times, i.e., that income is "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Glenshaw Glass* at 430. The Respondent's failure to apply this definition (and even its failure to clearly state it), indicates that Respondent and the Second Circuit seek to overturn *Glenshaw*, while paying lip service to its continued vitality.

THE EQUAL APPLICATION OF THE RULE OF LAW IN THE COURT'S USE OF THE DEFINITION OF INCOME

The Courts cannot uphold the equal application of justice to all litigants if it whipsaws the taxpayers before the courts regarding the definition of income. In hundreds of cases in which the broader definition of income of *Glenshaw* causes the taxpayer to be subject to income tax, the Courts have applied *Glenshaw*. In the case at hand and in *Gitlitz*, when the use of the broad *Glenshaw* definition would be beneficial to the taxpayer, the Commissioner in *Gitlitz*, and the

Tax Court and the Second Circuit in the case at hand, have either ignored the plain language of the statutes (Sections 108(a) and 118(a)) and/or reached back to century old case law and found that the item in question is not an item of income at all (excluded from gross income or otherwise). Likewise, the Tax Court and Second Circuit have refused to apply this Court's ruling in *Gitlitz* to the case at hand by stating that the type of income at issue in *Gitlitz* was listed explicitly in Section 61(a), while the type of income at issue in *Nathel* is not listed in Section 61(a). Any taxpayer attempting to make the same distinction – claiming that an item is not even included in gross income since it is not listed in Section 61 would be, and has been, summarily rejected, based on *Glenshaw*. See for example, *James v. U.S.*, 366 U.S. 213 (1961). The failure to be listed in Section 61(a) has never been the basis for excluding an accession to wealth from being included in gross income.

This Court has a stark choice, uphold the Second Circuit ruling, and by doing so overturn or undermine the Court's own definition of income from *Glenshaw* and its progeny, or reverse *Nathel* and require the Second Circuit to apply the *Glenshaw* definition of income to capital contributions, which is an "accession to wealth, clearly realized, and over which the taxpayer has complete dominion."

SECOND CIRCUIT PANEL FOUND THAT A CONTRIBUTION TO CAPITAL IS NOT INCOME, THUS NOT UNDER THE S CORP BASIS ADJUSTMENT RULES

For purposes of determining the S Corp basis adjustment rules, the Second Circuit looked to the general definition of income under Section 61, and concluded, mistakenly, that capital contributions are not gross income.

> However, while the question whether "income" in §1366(a)(1)(A) includes capital contributions has not been resolved, *courts frequently have addressed the scope of "income" as used in §61(a) and in the Sixteenth Amendment. Those cases indicate that capital contributions traditionally are not considered to be "income"* and, therefore, should not be considered "items of income" under §1366(a)(1)(A). [footnote omitted].

Nathel v. Commissioner, 615 F.3d 83 (2d Cir. 2010). App. 9.

CAPITAL CONTRIBUTIONS ARE GROSS INCOME UNDER *GLENSHAW GLASS*

Two Circuit Courts have already ruled that a contribution to capital is gross income under Section 61

Whether a contribution to capital is gross income has been answered by two Circuit Courts where, because the payment was not excluded from gross

income by Section 118 or another provision of the Code, the item was determined to be fully taxable. In the case of a partnership, a contribution to capital by a non-partner is not only gross income, but since it is not excluded from recognition by Section 721, it is taxable income recognized by the partnership. The Sixth and Tenth Circuits have declared that a contribution to capital is gross income, resolving this question.[2] In each case the contribution was not subject to Section 721 because the payor was not a partner, required for Section 721. *Mas One Limited Partnership v. U.S.*, 390 F.3d 427 (6th Cir. 2004); *Twenty Mile Joint Venture v. Commissioner*, 200 F.3d 1268 (10th Cir. 1999). To permit the Commissioner to whipsaw taxpayers and take the opposite position would be unconscionable.[3]

Unless the court concludes that some capital contributions are income and other identical ones are not, it is impossible to distinguish *Nathel* from *Mas One*. The facts are almost indistinguishable except the contribution in *Nathel* has been stipulated to be subject to Section 118, while in *Mas One*, the

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[2] This is also the Commissioner's general position, see **CO-ORDINATED ISSUE PAPER ALL INDUSTRIES EXCLUSION OF INCOME: NON-CORPORATE ENTITIES AND CONTRIBUTIONS TO CAPITAL UIL: 118.01-02 (2008)**. See also General Counsel Memorandum 38944 (1982).

[3] If the conclusion of the Second Circuit in *Nathel* is correct, the Circuit Court is disagreeing with the Sixth and Tenth Circuit panels and this issue should be taken by the Court for argument on the split between the Circuits.

contribution was not. It can be argued that under the logic of *Mas One*, even Section 118 does not apply to *Nathel* and the contribution is actually taxable income, since it was not made for a continuing interest in the corporation, but as part of a simultaneous cancellation of the shareholder's interest. Section 118 does apply to the contribution and excludes the contribution from taxable income only because Section 118 does not include the language of Section 721 that it be made "in exchange for an interest in the partnership." Section 721. Otherwise the contribution to the corporation in *Nathel* would not only be gross income, but also would be taxable income, indistinguishable from the outcome in *Mas One*.

Respondent is Mistaken Regarding Any Continuing Vitality to the Pre-*Glenshaw* Definitions of Income

Despite the Second Circuit's contention that this Court has "repeatedly emphasized the distinction between capital and income" and that *Glenshaw Glass* "did not overrule" this distinction, neither the Respondent nor the Second Circuit are able to cite to one case decided *after Glenshaw*[4] that defines income using the distinction between capital and income.

Before 1955 and *Glenshaw Glass*, there could be an honest intellectual debate whether an accession to

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[4] Other than *Nathel*.

wealth not based on capital or labor was income that could be subject to income tax. The opinion in *Glenshaw Glass* ended that debate, and clearly ruled that ***any*** accession to wealth (including, but not limited to income from capital or labor) which is controlled by the taxpayer is income which could be subject to income tax (sometimes deferred until recognition, i.e., Section 1001, or non-recognition provisions, i.e., Section 1033, Section 351, but also sometimes taxed annually on accretion without recognition, Sections 475(f) and 1256).

An earlier Second Circuit precedent practically ignored by the *Nathel* panel, *Collins*, supra at 630, noted the change in the law in 1955 with *Glenshaw*, and referring to this Court's refutation of *Eisner v. Macomber*, concluded, "The [Supreme] Court finally *abandoned* the stilted capital-labor formulation of gross income and *jettisoned* its earlier attempts to define the term in *Commissioner v. Glenshaw*." [emphasis supplied] (See Pet. at footnote 19.)

While prior to 1955, the Section 118 exclusion of capital contributions from gross income may have been a codification of the definition of gross income, after the *Glenshaw* opinion, Section 118 became an essential provision to prevent the taxation of capital contributions, since after 1955 they were otherwise includable in gross income, unless specifically excluded.

This change in law was recognized in 1958:

> The parties agree, as did the Tax Court, that *Edwards v. Cuba Railroad Co.*, supra, was

> followed by the Tax Court (and its predecessor Board of Tax Appeals) for some thirty years until the decision now under review. "In spite of the sheer weight in number of those decisions [pre-Glenshaw cases excluding capital contributions from gross income], we feel bound to make an ultimate finding consistent with that of the Detroit Edison case, and what in our view appears to be a gradually but persistently broadening concept of taxable income as exemplified by the Glenshaw Glass Co. and Gen. Investors Co. cases, supra."

Teleservice Co. of Wyoming Valley v. Comm., 254 F.2d 105 (3d Cir. 1958).

This Court has consistently applied the *Glenshaw* definition of income since 1955. See *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990). *Commissioner v. Kowalski*, 434 U.S. 77 (1977) and the cases listed at footnote 31 of the Petition. The Circuit courts continue to use *Glenshaw*, citing the definition. See *AT&T, Inc. v. U.S.*, 629 F.3d 505 (5th Cir. 2011).

Respondent and Second Circuit Are Also Mistaken in Relying on Treas. Reg. 118-1

Respondent, like the Second Circuit, argues that the Treasury Regulation 1.118-1 is "fatal" to the Petitioners' claim that a capital contribution is income, excluded from gross income by Section 118 itself. The Second Circuit refers to a single sentence

of the regulation that concludes: "such amounts do not constitute income." The regulation otherwise clearly states repeatedly that "an exclusion" from gross income is provided by the regulation. The regulation otherwise repeats and clarifies the statute regarding the "exclusion" from gross income, as stated in the statute and the regulation that is applicable. It is most likely that the regulation is an unclear indication that this is not "taxable income." This regulation addresses what is excluded from gross income, not the definition of gross income subject to possible exclusion. (That would be appropriate under the Section 61 regulations.)

While this hyper-sensitive analysis of the wording of a 50-year-old Treasury regulation is interesting, the Sixth and Tenth Circuits have already ruled otherwise. Both have ruled that a contribution to capital of a partnership is gross income, and if not subject to an exclusion or non-recognition provision, actually *taxable* income, not tax exempt. The IRS in recent statements and in its arguments in these two Circuits has held that the contributions are income. Both of these rulings and the IRS position trump a tea leaf analysis of a paragraph that uses the term "exclusion" three times and the phrase "amounts do not constitute income" once.

How the Second Circuit Should Have Applied *Glenshaw*

Applying the *Glenshaw* income test, the Second Circuit should have stated: the corporation having received a contribution of money, had an accession to wealth, and since it had no obligation to repay it, the corporation had complete dominion over the funds. This payment was an item of income, excluded from gross income since it was a capital contribution excluded from gross income by Section 118, per stipulation.

THE SECOND CIRCUIT DISTINGUISHED *GITLITZ* ON THE GROUNDS THAT *GITLITZ* INVOLVED AN ITEM THAT WAS GROSS INCOME LISTED IN SECTION 61(a) BEFORE EXCLUSION BY SECTION 108(a)

The Second Circuit offered the weakest of differentiation from the facts of *Gitlitz*, again, relying on the argument that capital contributions are uniquely not items of income:

> While the petitioners are correct that the list of items of income in §61(a) is not exclusive, the petitioners cannot rely on Gitlitz alone to overcome the long-standing treatment of capital contributions as distinct from income. Gitlitz did not create any new items of income. Gitlitz only held that the nature of discharge of indebtedness as income was not changed by the exclusion in §108(a). *Unlike*

> *this case [Nathel], the Commissioner in Gitlitz admitted that the item at issue – discharge of indebtedness – generally was included in gross income, but argued that the exclusion of discharge of indebtedness of insolvent entities in §108(a) altered the character of that item.* [emphasis added]

Nathel, 615 F.3d 83. App. 18.

As explained above, in the Sixth and Tenth Circuits, capital contributions clearly *are* gross income, that may be subject to exclusion (by Section 118 for corporations) or non-recognition (by Section 721 for partnerships).

When the Second Circuit stated in *Nathel* "We are not aware of any case that has held that capital contributions are "income" under Section 1366(a)(1)(A) or any other provision of the Code[.]" the panel did not consider the opinions in the Sixth and Tenth Circuits holding otherwise. In each of those cases the court held that the contribution to capital *was* income and taxable since not excluded by any other provision of the Code.

Without this differentiation from *Gitlitz*, the arguments of the Respondent fall away, and the Court's ruling in *Gitlitz* is directly applicable. The only means used to differentiate *Nathel* from *Gitlitz* was the fact that the item of income in *Gitlitz* is explicitly listed in Section 61(a) while the item of income in *Nathel* was not listed. If the clearly discredited argument that *Gitlitz* cannot be applied because

capital contributions are not listed in Section 61(a) is ignored, nothing stands in the way of the direct application of the *Gitlitz* rule – that the shareholder's capital contributions are items of income, excluded by Section 118, and are tax-exempt income for purposes of the S Corp basis adjustment rules of Section 1367.

This Court clearly stated the application of *Gitlitz* to Section 118 and all similar code sections:

> Not all items of income are included in gross income, see section 1366(a)(1) (providing that "items of income," including "tax-exempt" income, are passed through to shareholders), so mere exclusion of an amount from gross income does not imply that the amount ceases to be an item of income. Moreover, sections 101 through 136 employ the same construction to exclude various items from gross income: "Gross income does not include. . . ."

Gitlitz at 422.

BY STATUTE THE S CORP BASIS ADJUSTMENT RULES ARE INDEPENDENT OF THE C CORP RULES

The Tax Court objection that cardinal principles of C Corporation basis adjustment would be overturned is based on a misjudgment and erroneous application of C Corp rules to an S Corp transaction.

The application of the special S Corp basis adjustment rules for debt is required explicitly by an S Corp statute, Section 1367. The correct application of the S Corp basis adjustment rules for shareholder debt would not violate the cardinal rules that would continue to appropriately apply to all C Corps.

CONCLUSION

Petitioner renews the request for GVR in light of *Mas One*, which apparently was not known or considered by the Second Circuit.

For the reasons stated above, the Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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